Internal Revenue Service

memorandum

CC:TL:TS
HEARD/alb

date: MAY 4 1987

to: District Counsel, New Orleans SE:NO

from: Chief, Tax Shelter Branch CC:TL:TS

subject: Effect of New Legislation on Section 108 of the 1984 Revenue Act

Issues

1. Whether the "primarily for profit test" applies to an investor who claimed losses as the result of the disposition of a position in a straddle entered into and disposed of prior to June 24, 1981.

2. Whether Congressional comments outside those in the "formal" legislative history should have any impact on the above standard.

Conclusions

1. The Service and various courts have interpreted I.R.C. § 165(c)(2) to require a primarily for profit test. Glass v. Commissioner, 87 T.C. 1087 (1986); Fox v. Commissioner, 82 T.C. 1001, 1119-1122 (1984); Smith v. Commissioner, 78 T.C. 350 (1982). Investors who disposed of positions in straddles prior to June 24, 1981, are subject to this primarily for profit test.

2. All legislative comments will be studied by the courts in interpreting section 108 of the 1984 Revenue Act. However, more weight is given to the various committee reports than to statements in the Congressional Record. Contradictory comments

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1/ Under the Economic Recovery Tax Act of 1981 an a identified straddle is considered an open transaction until both legs of the straddle are closed out. I.R.C. § 1092(a)(2)(ii). Under prior law, investors could close the individual legs of a straddle separately in different years thus allowing them to take losses in early years and gains in later years with no overall gain or loss. This strategy was employed to offset and defer recognition of gain and to convert short term capital gain into long term capital gain.

by legislators should cancel each other out. Thus, the House Report, which overrules Miller and which the Conference Agreement impliedly adopted, should be determinative in favor of the Service.

Background

Section 1808(d) of the Tax Reform Act of 1986 (1986 Act) amends section 108 of the Tax Reform Act of 1984. The legislation and the attendant history relating to the House bill would effectively overrule Miller v. Commissioner, 84 T.C. 827 (1985), appeal docketed, No. 85-2766 (10th Cir. Nov. 20, 1985). Therefore, investor-taxpayers, in order to deduct straddle losses, would need to meet a "primarily for profit" standard in the transactions, while taxpayers who qualify as dealers will be presumed to have entered into their trades for a profit. Only treatment of the dealers is explicitly addressed in the 1986 Act.

The Conference Report of the 1986 Act did not specifically discuss Miller. It follows the House bill and, therefore, presumably the House Committee report. The House Committee report states that Congress did not intend in enacting section 108 to change the profit-motive standard of I.R.C. § 165(c)(2) or enact a new profit-motive standard for commodity straddle activities. In the Congressional Record dated September 27, 1986, at S 13956, as part of a colloquy between Senators Dole and Packwood, Senator Dole stated that:

> the statement of managers explaining the conference report did not include the language of the House report that discussed investors and that the conference report is the entire agreement of the conferees.

In the Congressional record dated October 2, 1986, at E 3391, House Ways and Means Committee Chairman Rostenkowski disagreed with the preceding colloquy stating:

> [T]he Senate receded to the House on this provision. Consistent will all other decisions of the conferees, where one House has receded to the position of the other, the recession includes not only the statutory provision, but also the complete legislative history evidenced in the committee report, as well as any additional clarifications provided in the statement of managers. Clearly, the legislative history of this provision as embodied in the House committee

> report is as much as part of the conference agreement as are relevant sections of the Senate committee report in instances where the House has receded to the Senate.

In the Congressional record dated October 17, 1986, at S 17055, Senator Packwood responded to a question by Senator Dole about this conflict as follows:

> As the majority leader well knows, this issue was the subject of some dispute during the conference on the Tax Reform Act. After the amount of discussion on the issue, it would seem unreasonable to believe that the Senate conferees intended to adopt language concerning these investors contained in the Ways and Means Committee report merely by remaining silent in the conference statement of managers.

Discussion

I.R.C. § 165(c) provides that losses deductible by an individual are limited to "(1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business;" and certain casualty losses. The courts have interpreted the phrase "transaction entered into for profit" in section 165(c)(2) as requiring a primary profit motive. See, Fox, supra at 1119-1122 and the cases cited therein. The losses incurred by investors in typical tax-motivated commodity straddles do not satisfy the primary profit motive test of section 165(c)(2). Fox, supra; Smith, supra.

The petitioners in Smith were real estate developers who used a butterfly straddle in silver to generate approximately $95,000 of short-term capital losses in 1973 and approximately $90,000 if long-term capital gains in 1974. By so doing the petitioners hoped to defer non-commodity short-term capital gainst realized in 1973 to 1974 and to convert them to long-term capital gains. The Tax Court held that the petitioners' straddle transactions were not profit motivated and, therefore, did not satisfy the requirements of section 165(c)(2).

Subsequently, in Fox, supra (decided prior to the enactment of section 108), the Court specifically adopted the already well established principle that, in order to satisfy the section 165(c)(2) of the Code "entered into for profit" test, the primary motive for the transaction must be profit oriented, rather than tax oriented.

Section 108(a) of the Tax Reform Act of 1984, provides, in general, that any loss from the disposition of one or more straddle positions shall be allowed for the taxable year of the disposition "if such disposition is part of a transaction entered into for profit." Under section 108(b), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts is rebuttably presumed to be part of a transaction entered into for profit. Section 108 is only applicable to straddle transactions not covered by the reform provisions contained in Title V of the Economic Recovery Tax Act of 1981. Section 108(a).

The Conference Committee Report accompanying section 108 references the phrase "entered into for profit" as follows:

> In determining whether the position is part of a transaction entered into for profit, it is intended that the provision be applied by treating the condition as satisfied if there is a reasonable prospect of any profit from the transaction.

In Miller, supra, the Commissioner argued that the "entered into for profit" language contained in section 108 requires utilization of the same "primarily for profit" subjective standard applicable for purposes of section 165(c)(2) of the Code. The Tax Court rejected this interpretation and concluded, based on the committee reports, that a deduction is allowed under section 108 if there was any prospect of earning the profit from the straddle transaction. The Tax Court followed Miller in Perlin v. Commissioner, 86 T.C. 388 (1986); Landreth v. Commissioner, T.C.M. 1985-413; Kurtz v. Commissioner, T.C.M. 1985-410, appeal docketed, No. 86-1024 (10th Cir. Jan. 7, 1986).

In Wehrly v. United States, 808 F.2d 1311 (9th Cir. 1987), the Ninth Circuit rejected the Commissioner's interpretation of section 108, as advanced in Miller. However, the Court apparently also rejected the Tax Court's objective test. Rather, the Court adopted a third interpretation of section 108 that straddle losses are deductible if the taxpayer had a profit motive for entering into the transaction even if the profit motive was not the dominant motive.

In Johnson v. Commissioner, 86-2 U.S.T.C. ¶ 9705 (Cl. Ct. 1986), the Claims Court concluded that a primary or dominant profit motive was not required for a loss from an equipment leasing transaction to be deductible. The Court stated that

the profit motive requirement of section 162 (and 212), as incorporated by reference in section 183(c), was satisfied by demonstrating that the transaction was engaged in with the objective of, and a reasonable chance of making, a reasonable profit apart from tax considerations. In light of the Supreme Court's statements in Commissioner v. Groetzinger, No. 85-1226 slip op. at 12 (U.S. Feb. 24, 1987), that "to be engaged in a trade or business...the taxpayer's primary purpose for engaging in the activity must be for income or profit," we believe the Tax Court, rather than the Claims Court, has adopted the proper profit motive standard.

Tax Reform Act of 1986

Subsequent to the Tax Court's opinion in Miller, section 108 of the Tax Reform Act of 1984 was amended by section 1808(d) of the Tax Reform Act of 1986. Paragraph (d)(1) of section 1808 amended section 108 by striking out the language "if such position is part of a transaction entered into for profit," and inserting in lieu thereof "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business." The language inserted into section 108(a) is identical to paragraphs (1) and (2) of subsection 165(c). The Report of the House Ways and Means Committee on section 1503 of H.R. 3838 (which became section 1808 of the Tax Reform Act of 1986) explains the purpose of the amendment to section 108 as follows:

> Section 108 also restated the general rule that losses from the disposition of a position in a straddle are only allowable if such position was part of a transaction entered into for profit. A majority of the United States Tax Court in Miller interpreted section 108 as providing a new, less strigent profit standard for losses incurred with respect to pre-1981 commodity straddles. It was not the intent of Congress in enacting section 108 to change the profit-motive standard of section 165(c)(2) or to enact a new profit-motive standard for commodity straddle activities. The technical correction is necessary to end any additional uncertainity created by the Miller case. H.R. Rep. No. 99-246, 99th Cong., 1st Sess. 911 (1986).

Shortly after the enactment of the Tax Reform Act of 1986, the Tax Court decided Glass, supra, a case involving various types of straddles executed on the London Metals Exchange. After

reviewing the amendments made by section 1808, the Tax Court concluded that those amendments revalidated the Smith and Fox opinions. The Court stated:

> In summary, then, amended section 108 traces the pattern of the loss provisions of sections 165(c)(1) and (2), and makes it clear that losses incurred by commodities dealers trading in commodities are deductible under section 108 since they are losses incurred in a trade or business. Investors on the other hand must meet the test of loss incurred in a transaction entered into for profit. In the context of commodity straddle transactions, the investor language parallels the section 165(c)(2) language which we construed in Smith and Fox, and (except as to commodities dealers) we think the effect of amended section 108 is to revalidate our holdings in those cases.

Section 108(b) Presumption

Originally, section 108(b) provided that the rebuttable presumption of a profit motive would apply to "a commodities dealer or any person regularly engaged in investing in regulated futures contracts." The 1986 Act amended section 108(b) to provide that this presumption applies only to a "commodities dealer." A commodities dealer, pursuant to section 108(f), is any taxpayer who at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Code.

Section 1402(i)(2)(B) of the Code defines a commodities dealer as a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodity Futures Trading Commission.

The Conference Report, with respect to the 1986 Act, states that the presumption should apply:

1. to an investment banker who regularly trades in commodities;

2. even if the commodity in question was not regularly traded;

3. even if traded on an exchange where the dealer was not a member;

4. even if an identical position was re-established; and

5. where there is a loss allocable to a dealer's interest in a partnership, S corporation, or trust.

Contradictory Legislative History

It is possible that petitioners may argue that the 1986 legislation did not overrule the Miller Tax Court decision since the profit standard for individual investors was not expressly changed in the statute and because some legislative comments contradict the House Report language. Nevertheless, the House Report is the best evidence of Congressional intent and will control interpretation of the 1986 legislation as outlined below.

The 98th Congress enacted the 1984 Tax Reform Act. The 99th Congress passed the 1986 Act. It is the intent of the enacting Congress that controls interpretation of a statute. Teamsters v. U.S., 431 U.S. 324, 354 n. 39 (1977); U.S. v. Vogel Fertilizer, 455 U.S. 16 (1982). Where a reasonable interpretation of a statute can be gleaned from its language and from legislative history prior to its enactment, it will rarely be overridden by subsequent legislative history. Consumer Product Safety Comm's v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980).

Given the closeness of the Miller decision (10-8), however, it is likely that a court would find the legislative history of the 1984 Act inconclusive and, thus, would look to later legislation for guidance.

When the precise intent of the enacting Congress is obscure, the views of a subsequent Congress are entitled to significant weight. Seatrain Shipbuilding v. Shell Oil, 444 U.S. 571, 597 (1980); Red Lion Broadcasting Co. v. FCC, 395 U.S. 367, 380-81 (1969) (statute enacted by later Congress which clarified statute enacted by earlier Congress, entitled to "great weight."); cf. Bell v. New Jersey, 461 U.S. 773 (1983) (view of later Congress does not establish definitely meaning of earlier enactment, but it has persuasive value.) Congressmens' statements must be considered with the reports of both Houses. Chrysler Corp. v. Brown, 441 U.S. 281, 311 (1979).

Since the Conference Report represents the final statement of terms agreed to by both houses of Congress, it is the most persuasive evidence of Congressional intent. Demby v. Schneiker, 671 F.2d 507, 510 (D.C. Cir. 1981); Davis v. Lukhard, 788 F.2d 973, 981 (4th Cir. 1986), cert. den., -U.S.-, 107 S. Ct. 231 (1986) (Conference report most

persuasive evidence next to statute itself of Congressional intent). For instance, in U.S. v. MacKenzie, 777 F.2d 811, 821 (2d Cir. 1985), cert. den., -U.S.-, 106 S. Ct. 2889 (1986), the Court found that the Senate Report controlled interpretation of a revenue statute because the Conference Committee Report stated that the Conference Agreement was "substantially the same as the Senate Amendment." In Miller v. Fed. Mine Safety Health Rev. Comm'n, 687 F.2d 194, 195 (7th Cir. 1985), the Court stated that "absent contrary legislative history, a clear statement in the principal committee report is powerful evidence of legislative purpose and may be given effect even if it is imperfectly expressed in statutory language." Thus, it is our position that the Conference Agreement impliedly adopts the House Report overruling the Miller standard.

If a court is persuaded that the meaning of the Conference Agreement is in doubt, the court will be obliged to give significant weight to the views of members of the Conference Committee and sponsors of the Bill. 2/ A recent Supreme Court case, however, indicates that statements by individual legislators should not be given controlling effect where they are inconsistent with statutory language and other legislative history. See Brook v. Pierce County, ____ U.S. ____, 106 S. Ct. 1834, 1840 (1986).

Thus, in Murphy v. Empire of America FSA, 746 F.2d 931, 935 (2d Cir. 1984), the Court stated that conflicting statements of Congressmen, during a House debate on a Conference Report, cancelled each other out. This holding is consistent with the statement of Congressman Rostenkowski that a colloquy about the 1986 Act would have to be "discussed in a substantially similar manner in, both the House and Senate" to be "considered as reflective of the conference agreement." 132 Cong. Rec. H8360 (daily ed. Sept. 25, 1986). Congressman Rostenkowski reiterated this statement in a floor statement on

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2/ See, e.g. National Woodwork Mfrs. Ass'n v. NLRB, 387 U.S. 612, 640 (1967) (Court must look to the sponsors of legislation when the meaning of the words of the enactment, and of the conference report, are in doubt); State of Kansas ex rel. Stephen v. Adams, 608 F.2d 861 (10th Cir. 1974), cert den, 445 U.S. 968 (1980) (As statements of one of the legislation's sponsors, congressman's remarks deserved to be accorded substantial weight in interpreting the statutes, and statements by others responsible for preparation of the bill were likewise accorded deference). But see Chrysler Corp. v. Brown, 441 U.S. 281, 311 (1979) ("[t]he remarks of a single legislator, even the sponsor, are not controlling in analyzing legislative history.")

October 2, 1986. 132 Cong. Rec. E3389 (daily ed. Oct. 2, 1986). See also Teuber, Colloquies: What They Are and What They Do, 33 Tax Notes 128, 128 (1986) (Contradictory statements made by chairmen of tax-writing committees concerning interpretation of various provisions of the 1986 Act "cancel each other out.") (quoting a press release statement of Tax Court Chief Judge Sterett).

In the presence of conflicting statements, a court will look to what Congress did rather than what various Congressmen said. American Airlines, Inc. v. C.A.B., 365 F.2d 939, 949 (D.C. Cir. 1966) (Reports by legislative committees responsible for formulating legislation must take precedence, in event of conflict, over statements in legislative debates). Accordingly, the Senate recession to the House bill is entitled to greater weight than the statements of either Congressman Rosenkowski or Senator Dole.

Current Cases on Appeal

The Ninth Circuit will revisit the Wehrly profit motive test for the first time after the 1986 Act in Landreth v. Commissioner, appeal filed, Nos. 86-7588 and 86-7636. The Tenth Circuit will address the profit motive test in the Miller appeal and also in Kurtz v. Commissioner, appeal filed, Nos. 86-1024 and 86-1025, (10th Cir. 1987). As soon as decision is reached in these cases we will send you a supplement to this memorandum. Any questions should be referred to Bill Heard at FTS 566-3361.

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